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SUBJECT: Indonesia - East Java/China Trade Growing, Investment  
Stalled, Leaders Frustrated

11. SUMMARY: China's legal exports to East Java were close to \$1 billion in 2006; illegal imports may have been double that amount. East Java shoe and garment industries have taken a beating from illegal imports, with over 500 small and medium sized firms closing in the past two years. So far, four large East Java shoe factories were bought out by Chinese producers to manufacture shoes specifically for the European Union (EU) in order to circumvent anti-dumping duties. Chinese companies have approached local manufacturers to facilitate illegal transshipments of shoes to the EU. Local trade officials are tightening Certificate of Origin (COO) controls to combat transshipment problems. Despite the increase in trading activity, Chinese investment in East Java dropped to \$33 million in 2006, a 67% reduction from 2005. To the disappointment of East Java leaders, China has invested little in meaningful, long-term projects which will increase employment, despite many promises. END SUMMARY.

East Java Producers Complain of Unfair Trade  
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12. (SBU) China has a growing trade relationship with East Java. Official Chinese exports to East Java have increased 300% since 2000, totaling \$985 million in 2006. Exports from East Java to China are growing at about 30% per year, totaling \$591 million in 2006 mostly in commodities and raw materials. However, official East Java figures on Chinese imports are misleading. Kresnayana Yahya, a prominent economic analyst and business consultant, estimates that another \$1-2 billion per year in cheap "knock-off" clothing, textiles, shoes and electronics are smuggled into Indonesia through Surabaya, thus avoiding payment of "official" duties in favor of paying bribes to local customs officials.

13. (SBU) Sutan Siregar, head of the East Java Shoe Manufacturer's Association told us that the influx of cheap, "duty free" Chinese goods has forced over 500 small and medium sized garment and shoe manufacturers catering to the domestic Indonesian market to close in the last two years. Large manufacturers continue to operate by reducing production and laying off thousands of workers. Welly Karlan, CEO of PT Golden Footwear Indonesia told us that his children's shoe manufacturing company is operating at only 30% of capacity. Due to competition from illegal imports from China, it has reduced the work force in three factories from 11,000 to 4,500

employees since 2005.

#### Chinese Investment in East Java Plummets in 2006

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14. (SBU) Chinese foreign direct investment (FDI) in East Java reached a cumulative \$5.3 billion in 2006, focused on trading, manufacturing, agriculture and natural resources. However, in 2006 Chinese directly invested only \$33 million in East Java, a 67% reduction from the \$99 million invested in 2005. According to Komang Warry, Head of the East Java Investment Promotion Board, most of the investments in 2006 were made by Chinese firms forming trading subsidiaries to import their own products made in China. Yahya also noted that Chinese firms may be less willing to invest locally since they seem to be able to easily circumvent import restrictions and/or duties on Chinese-made goods.

15. (SBU) One of the crown jewels of the CHINA-East Java investment relationship was the highly touted Sinpec-Pertamina Tuban oil refinery joint venture - a \$3 billion project. According to Edi Wahyudi, a member of the East Java parliament, Sinopec backed out of the huge project two months ago, before the scheduled late 2007 groundbreaking. Sinopec cited increasing construction costs and financial concerns due to Pertamina's inability to secure an oil supply from the Exxon Mobil-managed Cepu block. Chinese investors also abandoned an East Java power plant project committed to during President Yudhoyono's most recent visit to Beijing, according to Wahyudi.

16. (SBU) Chinese investors have shown interest in investing in shoe manufacturing in East Java but not for the local market. According to Siregar, in 2006, a group of investors signed joint venture agreements with Indonesian partners to take over 15 shoe factories

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(which were coincidentally underperforming due to competition from illegally imported Chinese-made shoes), agreeing to renovate and upgrade equipment and ultimately rehire 50-70,000 workers. The Chinese investors will produce shoes for the European market in Indonesia in order to avoid the 28% anti-dumping duties imposed by the EU on Chinese-made shoes. While the original plan called for an investment of over \$1.5 billion, including construction of their own electricity generation plant, the Chinese investors eventually scaled back their plans, so far taking over only four factories, with an estimated investment of \$40-60 million. One of the reasons cited for pulling back was transportation problems caused by the Sidoarjo mud volcano.

#### Transshipment - Less Risky Than Investing

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17. (SBU) In order to circumvent EU anti-dumping duties on shoes, Karlan told us that Chinese shoe manufacturers approached him with a scheme to re-export Chinese shoes to the EU. Karlan was guaranteed 1,000 containers per month at a rate of \$500 per container in exchange for providing an Indonesian Certificate of Origin (COO). Karlan said that transshipment offers are common but the penalties are stiff if caught and the costs of the bribes to secure the COOs would leave little profit margin.

18. (SBU) The stiff penalties and slim profit margin however are not always enough to dissuade local businesses from transshipment schemes. The chairman of East Java Trade and Industry Department (Disperindag) reported that two shrimp companies in Banyuwangi were recently caught manipulating COOs to transship Chinese shrimp to the U.S. (Note: Disperindag has the only authority to issue COOs in the province.) As a result of the newest scandal, Disperindag formed a task force to conduct regular inspections, reduced the number of offices with authority to issue COOs in the province from 19 to three, and are improving control and oversight of the process. East Java trade officials seem eager to avoid any additional transshipment problems.

Comment - Chinese FDI - Lots of Talk, Little Action

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19. (SBU) After the arrival (with much hoopla) of the new Chinese Consulate General in Surabaya in 2006, East Java political and business leaders were expecting a Chinese FDI bonanza. In the six months since it opened, data shows there have been more Chinese backed projects stopped than started. While expectations were admittedly high, China has delivered little despite many promises of major, job-creating investments, especially in infrastructure, leaving many local officials impatient and frustrated.

PIERANGELO/HEFFERN